

this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Internal Revenue Code of 1986.

(c) **TABLE OF CONTENTS.**—The table of contents for this Act is as follows:

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- Sec. 3. Permanent extension of election to treat combat pay as earned income for purposes of earned income credit.
- Sec. 4. Treatment of differential military pay as wages.
- Sec. 5. Permanent extension of penalty-free withdrawals from retirement plans by individual called to active duty.
- Sec. 6. State payments to service members treated as qualified military benefits.
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SEC. 2. EXTENSION OF STATUTE OF LIMITATIONS TO FILE CLAIMS FOR REFUNDS RELATING TO DISABILITY DETERMINATIONS BY DEPARTMENT OF VETERANS AFFAIRS.

(a) **IN GENERAL.**—Subsection (d) of section 6511 (relating to special rules applicable to income taxes) is amended by adding at the end the following new paragraph:

“(8) **SPECIAL RULES WHEN UNIFORMED SERVICES RETIRED PAY IS REDUCED AS A RESULT OF AWARD OF DISABILITY COMPENSATION.**—

“(A) **PERIOD OF LIMITATION ON FILING CLAIM.**—If the claim for credit or refund relates to an overpayment of tax imposed by subtitle A on account of—

“(i) the reduction of uniformed services retired pay computed under section 1406 or 1407 of title 10, United States Code, or

“(ii) the waiver of such pay under section 5305 of title 38 of such Code,

as a result of an award of compensation under title 38 of such Code pursuant to a determination by the Secretary of Veterans Affairs, the 3-year period of limitation prescribed in subsection (a) shall be extended, for purposes of permitting a credit or refund based upon the amount of such reduction or waiver, until the end of the 1-year period beginning on the date of such determination.

“(B) **LIMITATION TO 5 TAXABLE YEARS.**—Subparagraph (A) shall not apply with respect to any taxable year which began more than 5 years before the date of such determination.”.

(b) **EFFECTIVE DATE.**—The amendment made by subsection (a) shall apply to claims for credit or refund filed after the date of the enactment of this Act.

(c) **TRANSITION RULES.**—In the case of a determination described in paragraph (8) of section 6511(d) of the Internal Revenue Code of 1986 (as added by this section) which is

made by the Secretary of Veterans Affairs after December 31, 2000, and on or before the date of the enactment of this Act, such paragraph—

(1) shall not apply with respect to any taxable year which began before January 1, 2001, and

(2) shall be applied by substituting “the date of the enactment of the Defenders of Freedom Tax Relief Act of 2007” for “the date of such determination” in subparagraph (A) thereof.

SEC. 3. PERMANENT EXTENSION OF ELECTION TO TREAT COMBAT PAY AS EARNED INCOME FOR PURPOSES OF EARNED INCOME CREDIT.

(a) **IN GENERAL.**—Clause (vi) of section 32(c)(2)(B) (defining earned income) is amended to read as follows:

“(vi) a taxpayer may elect to treat amounts excluded from gross income by reason of section 112 as earned income.”.

(b) **EFFECTIVE DATE.**—The amendment made by this section shall apply to taxable years ending after December 31, 2007.

SEC. 4. TREATMENT OF DIFFERENTIAL MILITARY PAY AS WAGES.

(a) **INCOME TAX WITHHOLDING ON DIFFERENTIAL WAGE PAYMENTS.**—

(1) **IN GENERAL.**—Section 3401 (relating to definitions) is amended by adding at the end the following new subsection:

“(h) **DIFFERENTIAL WAGE PAYMENTS TO ACTIVE DUTY MEMBERS OF THE UNIFORMED SERVICES.**—

“(1) **IN GENERAL.**—For purposes of subsection (a), any differential wage payment shall be treated as a payment of wages by the employer to the employee.

“(2) **DIFFERENTIAL WAGE PAYMENT.**—For purposes of paragraph (1), the term ‘differential wage payment’ means any payment which—

“(A) is made by an employer to an individual with respect to any period during which the individual is performing service in the uniformed services while on active duty for a period of more than 30 days, and

“(B) represents all or a portion of the wages the individual would have received from the employer if the individual were performing service for the employer.”.

(2) **EFFECTIVE DATE.**—The amendment made by this subsection shall apply to remuneration paid after December 31, 2007.

(b) **TREATMENT OF DIFFERENTIAL WAGE PAYMENTS FOR RETIREMENT PLAN PURPOSES.**—

(1) **PENSION PLANS.**—

(A) **IN GENERAL.**—Section 414(u) (relating to special rules relating to veterans’ reemployment rights under USERRA) is amended by adding at the end the following new paragraph:

“(11) **TREATMENT OF DIFFERENTIAL WAGE PAYMENTS.**—

“(A) **IN GENERAL.**—Except as provided in this paragraph, for purposes of applying this title to a retirement plan to which this subsection applies—

“(i) an individual receiving a differential wage payment shall be treated as an employee of the employer making the payment,

“(ii) the differential wage payment shall be treated as compensation, and

“(iii) the plan shall not be treated as failing to meet the requirements of any provision described in paragraph (1)(C) by reason of any contribution or benefit which is based on the differential wage payment.

“(B) **SPECIAL RULE FOR DISTRIBUTIONS.**—

“(i) **IN GENERAL.**—Notwithstanding subparagraph (A)(i), for purposes of section 401(k)(2)(B)(i)(I), 403(b)(7)(A)(ii), 403(b)(11)(A), or 457(d)(1)(A)(ii), an individual shall be treated as having been severed from employment during any period the individual is performing service in the uniformed services described in section 3401(h)(2)(A).

“(ii) **LIMITATION.**—If an individual elects to receive a distribution by reason of clause (i), the plan shall provide that the individual may not make an elective deferral or employee contribution during the 6-month period beginning on the date of the distribution.

“(C) **NONDISCRIMINATION REQUIREMENT.**—Subparagraph (A)(iii) shall apply only if all employees of an employer (as determined under subsections (b), (c), (m), and (o)) performing service in the uniformed services described in section 3401(h)(2)(A) are entitled to receive differential wage payments on reasonably equivalent terms and, if eligible to participate in a retirement plan maintained by the employer, to make contributions based on the payments on reasonably equivalent terms. For purposes of applying this subparagraph, the provisions of paragraphs (3), (4), and (5) of section 410(b) shall apply.

“(D) **DIFFERENTIAL WAGE PAYMENT.**—For purposes of this paragraph, the term ‘differential wage payment’ has the meaning given such term by section 3401(h)(2).”.

(B) **CONFORMING AMENDMENT.**—The heading for section 414(u) is amended by inserting “AND TO DIFFERENTIAL WAGE PAYMENTS TO MEMBERS ON ACTIVE DUTY” after “USERRA”.

(2) **DIFFERENTIAL WAGE PAYMENTS TREATED AS COMPENSATION FOR INDIVIDUAL RETIREMENT PLANS.**—Section 219(f)(1) (defining compensation) is amended by adding at the end the following new sentence: “The term ‘compensation’ includes any differential wage payment (as defined in section 3401(h)(2)).”.

(3) **EFFECTIVE DATE.**—The amendments made by this subsection shall apply to years beginning after December 31, 2007.

(c) **PROVISIONS RELATING TO PLAN AMENDMENTS.**—

(1) **IN GENERAL.**—If this subsection applies to any plan or annuity contract amendment—

(A) such plan or contract shall be treated as being operated in accordance with the terms of the plan or contract during the period described in paragraph (2)(B)(i), and

(B) except as provided by the Secretary of the Treasury, such plan shall not fail to meet the requirements of the Internal Revenue Code of 1986 or the Employee Retirement Income Security Act of 1974 by reason of such amendment.

(2) **AMENDMENTS TO WHICH SECTION APPLIES.**—

(A) **IN GENERAL.**—This subsection shall apply to any amendment to any plan or annuity contract which is made—

(i) pursuant to any amendment made by this section, and

(ii) on or before the last day of the first plan year beginning on or after January 1, 2009.

(B) **CONDITIONS.**—This subsection shall not apply to any plan or annuity contract amendment unless—

(i) during the period beginning on the date the amendment described in subparagraph (A)(i) takes effect and ending on the date described in subparagraph (A)(ii) (or, if earlier, the date the plan or contract amendment is adopted), the plan or contract is operated as if such plan or contract amendment were in effect, and

(ii) such plan or contract amendment applies retroactively for such period.

SEC. 5. PERMANENT EXTENSION OF PENALTY-FREE WITHDRAWALS FROM RETIREMENT PLANS BY INDIVIDUAL CALLED TO ACTIVE DUTY.

Clause (iv) of section 72(t)(2)(G) (relating to distributions from retirement plans to individuals called to active duty) is amended by striking all after “September 11, 2001” and inserting a period.